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IN THE

Supreme Court of the United States

THE BOEING COMPANY AND
CONSOLIDATED SUBSIDIARIES,

Petitioners,

-v.-

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR NATIONAL FOREIGN TRADE COUNCIL, INC., AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE*

National Foreign Trade Council, Inc. ("NFTC"), is a not-for-profit corporation with over 300 member firms that are involved in international trade and investment.[1] NFTC is the oldest and largest U.S. business association exclusively devoted to international trade matters. NFTC's members, which include most of the largest U.S. manufacturing companies, account for a substantial percentage of all U.S. non-agricultural exports.

Members of NFTC have a vital interest in this case, which involves the resolution of a significant issue concerning federal income tax incentives for U.S. exporters. The decision below permits a Treasury regulation relating to the allocation of research and development ("R&D") expenses to undermine the intended operation of the domestic international sales corporation ("DISC") and foreign sales corporation ("FSC") provisions of the Internal Revenue Code, thereby depriving U.S. exporters of congressionally mandated tax benefits.

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[1] As required by Sup. Ct. R. 37.6, NFTC affirms that no counsel for a party in this case authored this brief in whole or in part and, furthermore, that no person or entity, other than NFTC, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Both parties consented to the filing of this brief; their written consents have been lodged with the Clerk of the Court.

PRELIMINARY STATEMENT

Congress enacted the DISC provisions of the Internal Revenue Code (I.R.C. §§ 991-997) in 1971 to encourage exports.[2] The DISC provisions permit U.S. taxpayers to obtain tax benefits by using a separate company — a DISC — as a vehicle for making export sales. A DISC is not itself subject to federal income tax. I.R.C. § 991(a). Instead, a tax is imposed at the shareholder level on approximately half of the DISC's profits. I.R.C. § 995(b). The remainder of the DISC's profits are generally not taxed until actually distributed. I.R.C. § 996. Since the benefit derived from a DISC is deferral of tax on approximately half of the DISC's earnings, it is to the taxpayer's advantage to maximize DISC profits. There are three methods available to determine the amount of a DISC's profits, and the taxpayer is entitled to use the one that produces the highest profits for the DISC. I.R.C. § 994(a).[3] One of the methods is the combined taxable income ("CTI") method. Under that method, a DISC is assigned 50 percent of the CTI of the DISC and its related supplier which is attributable to an export sale. I.R.C.

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[2] Unless otherwise indicated, all "§" references are to the Internal Revenue Code of 1954 (26 U.S.C.), or the Treasury regulations promulgated thereunder (26 C.F.R.), as in effect in 1979. Because there are no differences between the DISC and FSC provisions that are relevant to the issue in this case, this brief will discuss only the DISC rules, as did the court below. *See* Opin. 6a n.3. ("Opin." references are to the opinion of the court of appeals in this case, as reproduced in Appendix A to the Petition for a Writ of Certiorari.)

[3] Technically, these three methods are not applied directly to determine the amount of the DISC's profits. Rather, they are applied to "back into" the allowable intercompany transfer price between a DISC and its related supplier (typically its parent corporation). The profits of the DISC and the related supplier are then computed on the basis of that transfer price.

§ 994(a)(2). The dispute in this case centers on how R&D expenses should be taken into account in computing CTI.

Prior to 1984, The Boeing Company and Consolidated Subsidiaries ("Boeing") exported commercial aircraft through a DISC subsidiary. Boeing maintained a separate "Program" for each of its aircraft models. Boeing conducted two types of R&D: (1) "Blue Sky R&D" (basic R&D and R&D with respect to potential new models) and (2) "Program R&D" (R&D directly related to a particular aircraft model that the company had decided to produce). *See* Opin. 2a-3a.

The CTI attributable to an export sale equals the gross receipts from the sale minus the costs of the DISC and its related supplier that relate to the gross receipts. Treas. Reg. § 1.994-1(c)(6). Boeing elected to determine CTI by product lines. Treas. Reg. § 1.994-1(c)(7)(i). Accordingly, Boeing computed the CTI for each Program by taking the gross receipts from export sales in that Program and subtracting the costs related to those gross receipts. In computing CTI for each Program, Boeing took into account all of the Program R&D expenses associated with that particular Program (as well as a portion of the Blue Sky R&D expenses). The court below rejected Boeing's approach and held that Treas. Reg. § 1.861-8(e)(3) required Boeing to take into account a ratable portion of the total R&D expenses for all Programs in computing CTI for each separate Program. Consequently, the amount of CTI for a particular Program would be reduced by a portion of the R&D expenses associated with a different Program. The Eighth Circuit, in *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (8th Cir. 1994), had previously held that Treas. Reg. § 1.861-8(e)(3) could not be validly applied in such a fashion in the computation of CTI.

SUMMARY OF ARGUMENT

The Eighth Circuit got it right in *St. Jude Medical*. The Ninth Circuit got it wrong. The decision below is based on a fundamental misunderstanding. The DISC legislative history, the DISC regulations, and Treas. Reg. § 1.861-8 all recognize only two categories of deductions: (1) those that are *definitely* related to *some* gross income and (2) those that are *not* definitely related to *any* gross income. The court below concocted another category: deductions that are *indefinitely* related to *some* gross income. Only on the basis of that concoction was the court able to conclude that Treas. Reg. § 1.861-8(e)(3) does not conflict with Congress' intent and the DISC regulations.

As written, Treas. Reg. § 1.861-8(e)(3) cannot be validly applied in computing DISC CTI. Since the DISC regulations do not mandate that Treas. Reg. § 1.861-8(e)(3) be applied mechanically, it should be applied, if at all, *mutatis mutandis* on the basis of the taxpayer's product lines, rather than on the basis of broad product categories. That way, Treas. Reg. § 1.861-8(e)(3) can be harmonized with the DISC regulations and applied to effectuate, rather than thwart, Congress' intent.

ARGUMENT

I. THE NINTH CIRCUIT ERRED IN HOLDING THAT TREAS. REG. § 1.861-8(e)(3) COULD BE VALIDLY APPLIED TO REQUIRE R&D EXPENSES TO BE ALLOCATED AND APPORTIONED ON THE BASIS OF BROAD PRODUCT CATEGORIES RATHER THAN BOEING'S CTI PRODUCT LINES.

A. The Decision Below Was Based on a Fundamental Misunderstanding of the Provisions Involved.

The Ninth Circuit held that Treas. Reg. § 1.861-8(e)(3) could be validly applied to require Boeing to subtract R&D expenses related to *one* product line in computing DISC CTI for *other* product lines. That holding was premised on a fundamental misunderstanding of how Treas. Reg. § 1.861-8 and the DISC provisions work. The court of appeals' reasoning is fatally flawed and should be rejected.

1. The DISC provisions

Under the CTI method, the CTI of a DISC and its related supplier that is attributable to a sale of export property is split 50-50 between the DISC and the related supplier. I.R.C. § 994(a)(2). The legislative history of I.R.C. § 994 indicates that Congress intended for the CTI attributable to a sale of export property to be determined "generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country." H.R. Rep. No. 92-533, at 74 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1887; S. Rep. No. 92-437, at 107 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 2013. Congress summarized those "principles" in this way: "These

rules generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis." *Id.* The committee reports continue:

> Thus, the combined taxable income of a DISC and a related person with respect to the sale by the DISC of export property would be determined by deducting from the DISC's gross receipts the related person's cost of goods sold with respect to the property, the selling, overhead and administrative expenses of both the DISC and the related person which are directly related to the production or sale of the export property and a portion of the related person's and the DISC's expenses not allocable to any specific item of income, such portion to be determined on the basis of the ratio of the combined gross income from the export property to the total gross income of the related person and the DISC.

H.R. Rep. No. 92-533, at 74, *reprinted in* 1971 U.S.C.C.A.N. at 1887-88; S. Rep. No. 92-437, at 107-08, *reprinted in* 1971 U.S.C.C.A.N. at 2013-14.

Consistent with the legislative intent, the DISC regulations define CTI from a sale of export property as "the excess of gross receipts . . . of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts." Treas. Reg. § 1.994-1(c)(6). The regulations further provide:

> Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated

> and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

Treas. Reg. § 1.994-1(c)(6)(iii).

Thus, both the legislative history and the DISC regulations contemplate two types of costs that are to be deducted from gross receipts to determine CTI: (1) all costs "directly" or "definitely" related to the gross receipts (cost of goods sold, selling expenses, overhead, and administrative expenses are mentioned) and (2) a portion of other expenses that are not "allocable" or "definitely related" to a specific item or class of gross income, which are to be spread ratably over all of the gross income of the DISC and the related supplier.

The pricing rules embodied in I.R.C. § 994 (including the CTI method) "generally are to be applied on a product-by-product basis" but "may be applied on the basis of product lines." H.R. Rep. No. 92-533, at 74, *reprinted in* 1971 U.S.C.C.A.N. at 1888; S. Rep. No. 92-437, at 108, *reprinted in* 1971 U.S.C.C.A.N. at 2014. The DISC regulations provide that, "[g]enerally, the determinations under [Treas. Reg. § 1.994-1] are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines." Treas. Reg. § 1.994-1(c)(7)(i). The regulations go on to state that a taxpayer's determination of a product or product line "will be accepted" by the Internal Revenue Service ("IRS") as long as it conforms to "a recognized industry or trade usage" or to "the two-digit major groups (or any inferior classifications or combinations thereof, within a major group)" of the Office of

Management and Budget's Standard Industrial Classification ("SIC") Manual. Treas. Reg. § 1.994-1(c)(7)(ii).

Finally, the DISC regulations provide an explicit link between the allocation and apportionment of costs to export-related gross receipts and the taxpayer's choice of transaction groupings: "In determining the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, . . . [t]he taxpayer's choice in accordance with [Treas. Reg. § 1.994-1(c)(7)] as to the grouping of transactions shall be *controlling*, and costs deductible in a taxable year shall be *allocated and apportioned to the items or classes of gross income . . . resulting from such grouping.*" Treas. Reg. § 1.994-1(c)(6) (emphasis added).

2. Treas. Reg. § 1.861-8

Treas. Reg. § 1.861-8 is a provision of general application that "prescrib[es] rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively . . . as 'deductions')" for purposes of "determining taxable income of the taxpayer from specific sources and activities" under various sections of the Internal Revenue Code, referred to as "operative sections." Treas. Reg. § 1.861-8(a)(1). After the gross income from the relevant source or activity has been determined, the amounts that must be subtracted to reach taxable income are determined under a two-step process: The taxpayer's deductions are first *allocated* and then they are *apportioned.*

Generally, a deduction is *allocated* to the "class of gross income" to which the deduction is "definitely related." Treas. Reg. § 1.861-8(b)(1). "The classes of gross income are not predetermined but must be determined on the basis of the

deductions to be allocated." *Id.* Thus, a "class of gross income" may consist of more than one type or category of gross income. The rules for determining the class of gross income to which a deduction is definitely related "emphasize the factual relationship between the deduction and a class of gross income." *Id.* A deduction is "considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived." Treas. Reg. § 1.861-8(b)(2).

The regulations indicate that most deductions will be definitely related to some class of a taxpayer's total gross income. Treas. Reg. § 1.861-8(b)(1). If a deduction is not definitely related to some class of a taxpayer's total gross income, it is ordinarily "treated as definitely related and allocable to *all* of the taxpayer's gross income." Treas. Reg. § 1.861-8(b)(5) (emphasis added). Only a handful of specified deductions (e.g., those for charitable contributions, real estate taxes on a personal residence, and medical expenses) are treated as not definitely related to *any* gross income. Treas. Reg. § 1.861-8(e)(9).

Where a deduction is allocated to a class of gross income that is included in one or more "statutory groupings" of gross income and the "residual grouping" of gross income, the deduction must then be *apportioned* between (or among) the statutory grouping(s) and the residual grouping. Treas. Reg. § 1.861-8(c)(1).[4] For purposes of calculating DISC CTI, there would be a statutory grouping for each CTI product line

[4] "Statutory grouping" means "the gross income from a specific source or activity which must first be determined in order to arrive at taxable income from such specific source or activity under an operative

(footnote continued)

consisting of the gross income (i.e., the DISC's gross receipts minus the related supplier's cost of goods sold) from sales of the product line.

A deduction is apportioned by attributing the deduction to the statutory grouping(s) and the residual grouping. "Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income." *Id.*[5] Where a deduction is treated as not definitely related to *any* gross income, however, the deduction is always *ratably* apportioned between (or among) the statutory grouping(s) and the residual grouping — i.e., the same proportion of the deduction is apportioned to each grouping as the amount of gross

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(footnote continued)

section. . . . Gross income from other sources or activities is referred to as the . . . 'residual grouping.'" Treas. Reg. § 1.861-8(a)(4). Thus, for example, if the operative section required the determination of taxable income from Virgin Islands sources, the statutory grouping would be the taxpayer's gross income from Virgin Islands sources and the residual grouping would be all the taxpayer's other gross income.

[5] Examples of "bases and factors" that should be considered in determining the method of apportionment for a particular deduction include:

(i) Comparison of units sold;
(ii) Comparison of the amount of gross sales or receipts;
(iii) Comparison of costs of goods sold;
(iv) Comparison of profit contribution;
(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class of gross income; and
(vi) Comparison of the amount of gross income.

Treas. Reg. § 1.861-8(c)(1).

income in the grouping bears to the total amount of gross income. Treas. Reg. § 1.861-8(c)(2).

Treas. Reg. § 1.861-8(e) contains special rules for the allocation and apportionment of specific types of deductions (e.g., interest, legal and accounting fees, and income taxes). Treas. Reg. § 1.861-8(e)(3) provides the specific rules for the allocation and apportionment of R&D expenses. That regulation states that R&D expenses are ordinarily considered "deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class . . . related to such product category (or categories)." Treas. Reg. § 1.861-8(e)(3)(i)(A). If the R&D is not clearly identified with any product category (or categories), it is considered to be conducted with respect to all the taxpayer's product categories. *Id.* The regulation goes on to list the "broad product categories" to which a taxpayer is limited. Those categories are based on the SIC two-digit major groups.[6]

Treas. Reg. § 1.861-8(e)(3) departs from the over-arching "factual relationship" standard enunciated in Treas. Reg. § 1.861-8(b)(1). It departs from the principle that classes of gross income are not predetermined. It requires taxpayers to allocate R&D expenses to all the gross income in a broad, predetermined SIC product category — including gross income to which the expenses may bear *no* factual relationship. In the context of DISC CTI computations, if applied literally, it would require taxpayers to treat R&D expenses

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[6] The "broad product categories" encompass anywhere from one to 15 SIC major groups. All of Boeing's Programs fell within the broad product category "transportation equipment" (SIC major group 37).

that are factually related to *one* CTI product line as costs relating to export sales in *other* CTI product lines.

3. The decision below

The Ninth Circuit concluded that Treas. Reg. § 1.861-8(e)(3)'s imposition of a "deemed" relationship between R&D expenses and broad, predetermined categories of gross income is consistent with the legislative history of the DISC provisions and with the DISC regulations. The court misinterpreted the legislative history, the DISC regulations, and Treas. Reg. § 1.861-8(e)(3), all of which recognize only two types of deductions: (1) deductions that are *definitely* (or directly) related to *some* gross income and (2) deductions that are *not* definitely (or directly) related to *any* gross income. The court of appeals, in its confusion, thought there was a third, hybrid category of deductions — those that are "indefinitely" related to *some* gross income. The court was thus able to view R&D expenses that were clearly identified with *one* of Boeing's CTI product lines as "indefinitely" related to *all* of its product lines.

First, the court explained, "House Report [92-533] reflects that Congress recognized some of the costs incurred in a given tax year would not be 'directly related' to specific income items. The report further reflects Congress' intention that those costs not 'directly related' would be allocated [sic] to export-related sales on a pro rata basis." Opin. 11a. The court concluded that "[t]he Commissioner's application of Treas. Reg. § 1.861-8(e)(3) effectuates this Congressional intent." *Id.* The court of appeals was also able to conclude that "[t]here is no conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(6)." Opin. 12a. The court reasoned:

> Treas. Reg. § 1.994-1(c)(6) contemplates that costs which are not "definitely related" to specific items of income . . . will be allocated [sic] to the combined taxable income of the taxpayer's export-related business. Treas. Reg. § 1.994-1(c)(6) is clear in explaining that "total costs . . . which relate to" . . . export sales . . . include both "definitely" and "indefinitely" related costs.

Id.

The problem with the court's reasoning is that Treas. Reg. § 1.861-8(e)(3) simply does not treat R&D expenses as not "directly" or "definitely" related to any class of gross income, or as "indefinitely" related to some gross income. Rather, it deems R&D expenses to be *definitely related*, and therefore *allocable*, to either (1) the gross income related to the broad SIC product category (or categories) with which the R&D is clearly identified or (2) the gross income related to all the taxpayer's SIC product categories (if the R&D is not clearly identified with any particular SIC product category (or categories)). The fact that Congress intended, and Treas. Reg. § 1.994-1(c)(6)(iii) requires, a ratable portion of "nonallocable" expenses (expenses that are ratably *apportioned* to *all* of the taxpayer's gross income) to be taken into account in the computation of CTI provides no basis for sustaining Treas. Reg. § 1.861-8(e)(3)'s treatment of R&D expenses that are clearly identified with *one* CTI product line as "definitely related," and therefore *allocable*, to the gross income from other CTI product lines.

Finally, the court below concluded:

> To the extent there is any tension between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(7),

> the regulations can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become "indirectly" or "indefinitely" related to specific items of income. The taxpayer is required, nonetheless, to apportion [sic] these costs to broader categories of income and allocate [sic] them between the taxpayer's export and domestic sales by the proportional method set forth in Treas. Reg. § 1.861-8(e)(3). Interpreted in this way, the regulations may be read to give effect to both.

Opin. 12a.

The Ninth Circuit's attempt at "harmoniz[ation]" does not make any sense. It is based entirely on the court's own amorphous concept of "indirectly" or "indefinitely" related costs — a concept that is to be found in neither Treas. Reg. § 1.861-8(e)(3) nor the DISC regulations.

Contrary to the Ninth Circuit's view, the more narrowly a taxpayer chooses to define items or categories of income, the more costs may become *definitely* related to more than one item or category of income. If a taxpayer makes red and blue widgets and chooses to "define" its income as "income from red widgets" and "income from blue widgets" (instead of simply as "income from widgets"), its widget-related costs do not suddenly become "indirectly" or "indefinitely" related to its red-widget income and blue-widget income. Those costs certainly do not become "not definitely related" to *any* item or category of gross income (and thus ratably apportionable to *all* the taxpayer's gross income, including interest, dividends, and income from any other lines of business the taxpayer may have). Rather, those costs (other than costs related solely to the widgets' redness or blueness)

become *definitely* related to two categories of income — the red-widget income and the blue-widget income.

When a taxpayer chooses under Treas. Reg. § 1.994-1(c)(7) to group DISC transactions by product lines (rather than broader categories), more R&D expenses may be definitely related to more than one CTI product line — if, in fact, the R&D is clearly identified with more than one product line. But under the Ninth Circuit's application of Treas. Reg. § 1.861-8(e)(3) in the computation of CTI, Boeing's choice as to the grouping of transactions is made irrelevant. Under the Ninth Circuit's reading, for purposes of allocating R&D expenses, Boeing is treated as if it had chosen to group transactions in accordance with the broad SIC categories. As a result, the expenses for R&D clearly identified with only one CTI product line are treated as definitely related to the income from all of Boeing's CTI product lines. The Ninth Circuit's reading ignores the significance conferred by the DISC regulations on Boeing's choice of transaction groupings.

The decision below is hopelessly flawed. It attempts to "harmonize[]" Treas. Reg. § 1.861-8(e)(3) with the DISC regulations on the basis of the court's mistaken beliefs that the DISC regulations require "indirectly" or "indefinitely" related costs to be taken into account in computing CTI and that Treas. Reg. § 1.861-8(e)(3) treats Boeing's R&D expenses as "indirectly" or "indefinitely" related to the income from all of Boeing's CTI product lines. The fundamental premise justifying the Ninth Circuit's decision is simply wrong.

B. The Literal Language of Treas. Reg. § 1.861-8(e)(3) Cannot Be Harmonized with the DISC Regulations.

Unlike the Ninth Circuit, the Eighth Circuit in *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (8th Cir. 1994), found an irreconcilable conflict between Treas. Reg. § 1.994-1, which permits a taxpayer to compute CTI on the basis of product lines, and Treas. Reg. § 1.861-8(e)(3), which requires the allocation of R&D expenses to the income from broad SIC categories. The Eighth Circuit found that "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines," and that "the deemed relationship mandated by § 1.861-8(e)(3)(i) is inconsistent with Congress's intent to 'generally allocate to each item of gross income all expenses *directly related thereto.*'" 34 F.3d at 1401. Based on "the origin and purpose of the DISC statute," the court held that Treas. Reg. § 1.861-8(e)(3) is "unreasonable, and thus invalid, as applied to DISC CTI computations." 34 F.3d at 1402.

The Eighth Circuit got it right in *St. Jude Medical*. The literal language of Treas. Reg. § 1.861-8(e)(3) cannot be harmonized with the provisions of Treas. Reg. § 1.994-1. The DISC regulations clearly carry out Congress' intent in enacting the DISC provisions: In determining CTI from export sales, expenses *directly related* to the gross income from each of the taxpayer's chosen CTI product lines are to be allocated to that gross income. The Ninth Circuit's application of Treas. Reg. § 1.861-8(e)(3) in this case to compute Boeing's CTI is invalid. The decision below should be reversed.

II. TREAS. REG. § 1.861-8, AS INVOKED BY TREAS. REG. § 1.994-1(c)(6)(iii), SHOULD BE APPLIED *MUTATIS MUTANDIS* IN COMPUTING CTI BY TREATING THE TAXPAYER'S CTI PRODUCT LINES AS THE RELEVANT PRODUCT CATEGORIES.

A. Treas. Reg. § 1.861-8(e)(3) Can Be Harmonized with the DISC Regulations by Applying the Methodology of Treas. Reg. § 1.861-8(e)(3) to CTI Product Lines Instead of SIC Categories.

The Ninth Circuit rightly recognized that it should, if possible, harmonize Treas. Reg. § 1.861-8(e)(3) with Treas. Reg. § 1.994-1(c)(7) so that "the regulations may be read to give effect to both. See, *e.g.*, *United States v. Borden Co.*, 308 U.S. 188, 198, 84 L. Ed. 181, 60 S. Ct. 182 (1939) ('It is a cardinal principle of construction that . . . [w]hen there are two acts upon the same subject, the rule is to give effect to both if possible.'); *see also Black & Decker Corp. v. Commissioner*, 986 F.2d 60, 65 (4th Cir. 1993) (explaining that the tenets of statutory construction apply with equal force to the interpretation of regulations)." Opin. 12a. The fact that the Ninth Circuit's attempt at harmonization was hopelessly flawed does not mean that harmonization is impossible.

The legislative history of the DISC provisions states that CTI is to be determined "generally in accordance with the principles applicable under section 861." H.R. Rep. No. 92-533, at 74 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1887; S. Rep. No. 92-437, at 107 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1918, 2013. Treas. Reg. § 1.994-1(c)(6)(iii) requires that the costs definitely related to the gross receipts from a CTI product line and a ratable portion of the costs not

definitely related to a class of gross income be "determined in a manner consistent with the rules set forth in Treas. Reg. § 1.861-8." The cross-reference to Treas. Reg. § 1.861-8 "does not mean that the very words of [that provision] must be lifted bodily from their context and applied mechanically" in the computation of CTI. *Cox v. Roth*, 348 U.S. 207, 209 (1955); *see also Bowen v. Michigan Academy of Family Physicians*, 476 U.S. 667, 673 (1986); *Shalala v. Illinois Council on Long Term Care, Inc.*, 529 U.S. 1, 18 (2000). Certainly, nothing in the cross-referencing language suggests that Treas. Reg. § 1.861-8(e)(3) should be "lifted bodily" and "applied mechanically" in the computation of CTI to the extent that provision is inconsistent with the DISC regulations.

If a taxpayer's CTI product lines are substituted for the SIC product categories, Treas. Reg. § 1.861-8(e)(3) can be harmonized with the DISC regulations. Interpreted in this way, Treas. Reg. § 1.861-8(e)(3) effectuates, rather than overrides, the DISC regulations' prescriptions that (1) costs treated as relating to gross receipts from sales of export property include "the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto," Treas. Reg. § 1.994-1(c)(6)(iii), and (2) the taxpayer may choose to make the determinations under Treas. Reg. § 1.994-1 on the basis of product lines, Treas. Reg. § 1.994-1(c)(7). Thus, for purposes of computing DISC CTI, R&D deductions should "ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant [CTI product line (or lines)] of the taxpayer and therefore allocable to all items of gross income as a class related to such [CTI product line (or lines)]." Treas. Reg. § 1.861-8(e)(3)(i)(A). Where R&D is "not clearly identified with any [CTI product line (or lines)], it [should] be considered conducted with respect to all the taxpayer's [CTI product lines]." *Id.* Any other approach

results in R&D that is factually related to one CTI product line being taken into account in computing CTI for other product lines. And that result is inconsistent with the structure and purpose of the DISC provisions.[7]

B. The Allocation and Apportionment of R&D Deductions on the Basis of CTI Product Lines, Rather Than SIC Categories, Is Consistent with the History and Policy of the Relevant Statutory and Regulatory Provisions.

The approach of applying Treas. Reg. § 1.861-8(e)(3) *mutatis mutandis* in computing DISC CTI is strongly supported by an examination of Treas. Reg. § 1.861-8 as it existed when Congress enacted the DISC provisions and when the Treasury Department promulgated the DISC regulations.

In 1971, Congress stated that expenses should be allocated and apportioned for purposes of CTI computations "generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country." H.R. Rep. No. 92-533, at 74, *reprinted in* 1971 U.S.C.C.A.N. at 1887; S. Rep. No. 92-437, at 107, *reprinted in* 1971 U.S.C.C.A.N. at 2013. Congress also indicated that "[t]hese rules generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis." *Id.*

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[7] An illustration of the application of Treas. Reg. § 1.861-8(e)(3) *mutatis mutandis* in computing CTI is set forth in the Appendix to this brief.

In 1971, Treas. Reg. § 1.861-8, promulgated in 1957 and captioned "Computation of taxable income from sources within the United States," contained the following general rule, which merely reproduced the language of I.R.C. § 861(b):

> From the items of gross income specified in §§ 1.861-2 to 1.861-7, inclusive, as being income from sources within the United States *there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto* and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.

Treas. Reg. § 1.861-8(a) (1957) (emphasis added). The regulations contained no "rules" for determining *how* deductions were to be "properly apportioned or allocated" to income from U.S. sources.

Regulations proposed in 1966 restated the general rule quoted above almost verbatim. Prop. Treas. Reg. § 1.861-8(a)(1) (1966).[8] In addition, the proposed regulations contained rules for allocating and apportioning deductions. Under the proposed regulations, a deduction "definitely related" to gross income would be *allocated* and, if necessary, *apportioned* to such income. Prop. Treas. Reg. § 1.861-8(a)(2)(i) (1966). A deduction would be considered "definitely related" to gross income if it was "incurred in

[8] 31 Fed. Reg. 10,394, 10,405 (Aug. 2, 1966).

whole or in material part as a result of, or incidental to, the activities from which such gross income is derived." Prop. Treas. Reg. § 1.861-8(a)(3)(i) (1966).

Thus, when Congress enacted the DISC provisions, the "principles applicable under section 861" could be applied only by analogy in computing DISC CTI (since Treas. Reg. § 1.861-8 applied, by its terms, only to the calculation of taxable income from sources within the United States), and there were no "rules" on how to allocate and apportion expenses in the final regulations. The 1966 proposed regulations, however, had rules regarding the allocation and apportionment of "definitely related" expenses. Those are the "rules" that Congress paraphrased in the DISC legislative history.

The DISC regulations were proposed in 1972.[9] The proposed regulations provided that costs relating to gross receipts from sales of export property included "deductions *properly apportioned or allocated* thereto, . . . determined in a manner consistent with the rules set forth in § 1.861-8." Prop. Treas. Reg. § 1.994-1(c)(6)(iii) (1972) (emphasis added). Again, Treas. Reg. § 1.861-8 could apply only by analogy for purposes of computing CTI. That fact (together with the fact that Treas. Reg. § 1.861-8 (1957) contained no rules for "properly" apportioning or allocating deductions) presumably dictated the drafters' choice of the phrase "in a manner consistent with" when cross-referencing Treas. Reg. § 1.861-8. By contrast, the provision relating to cost of goods sold used the phrase "shall be determined *in accordance with the provisions* of § 1.61-3." Prop. Treas. Reg. § 1.994-1(c)(6)(ii) (1972) (emphasis added). Therefore, the origin of the cross-referencing language in Treas. Reg.

[9] 37 Fed. Reg. 19,625 (Sept. 21, 1972).

§ 1.994-1(c)(6)(iii) strongly supports the notion that Treas. Reg. § 1.861-8 need not be applied mechanically.

When the DISC regulations were finalized in 1975,[10] the 1966 proposed regulations had been replaced by Prop. Treas. Reg. § 1.861-8 (1973).[11] The 1973 proposed regulations were captioned "Computation of taxable income from sources within the United States and from other sources and activities." They provided rules for determining taxable income from specific sources and activities under various operative sections of the Internal Revenue Code.

The 1973 proposed regulations also provided specific rules for allocating R&D expenses:

> Expenditures for research and development . . . shall be considered deductions which are definitely related to the class of gross income to which such research and development activity gives rise or is reasonably expected to give rise and shall be allocated to such class. Where research and development is intended to create, or is reasonably expected to result in the creation of, specific intangible properties or processes, or is intended or is reasonably expected to result in the improvement of specific properties or processes, deductions in connection with such research and development shall be considered definitely related and therefore allocable to the class of gross income to which the properties or processes give rise or are reasonably expected to give rise. . . . In other cases, as in the case of most basic research, research and

[10] T.D. 7364, 1975-2 C.B. 315.

[11] 38 Fed. Reg. 15,840 (June 18, 1973).

> development shall generally be considered definitely related and therefore allocable to all gross income . . . which is likely to benefit from the research and development.

Prop. Treas. Reg. § 1.861-8(e)(3) (1973).[12]

The 1973 proposed regulations also contained an example which illustrates in no uncertain terms that, at the time the final DISC regulations cross-referenced Treas. Reg. § 1.861-8, R&D expenses were intended to be allocated as Boeing allocated its R&D expenses. Prop. Treas. Reg. § 1.861-8(g), *Example (1)* (1973), involved a domestic corporation (X) that manufactured 4-, 6-, and 8-cylinder engines. The example concluded that X's deductions for R&D expenses in connection with general research were definitely related to the gross income to which all engines gave rise. The example went on to deal with product-specific R&D and concluded that X's deductions for its R&D expenses in connection with the 4-cylinder engine, the 6-cylinder engine, and the 8-cylinder engine were, in each case, definitely related to the gross income to which the particular engine gave rise.

Prop. Treas. Reg. § 1.861-8(g), *Example (2)* (1973), dealt expressly with the computation of DISC CTI. X sold 4- and 6-cylinder engines to its wholly owned DISC (Y). The example noted that "X and Y group[ed] transactions on the basis of each of the two products sold (four- and six-cylinder

[12] The mandatory SIC product categories in Treas. Reg. § 1.861-8(e)(3) were first introduced in 1976 (after the DISC regulations were finalized), when the 1973 proposed regulations were withdrawn and new regulations were proposed. 41 Fed. Reg. 49,160 (Nov. 8, 1976). The 1976 proposed regulations were finalized in 1977. T.D. 7456, 1977-1 C.B. 200.

engines),"[13] with a specific cross-reference to Prop. Treas. Reg. § 1.994-1(c)(7) (1972), and "determine[d] transfer prices charged on the basis of the '50-50' combined taxable income method." The example concluded: "As the initial step in computing the deductions which must be taken into account for purposes of determining combined taxable income of X and Y from DISC sales, X's deductions for its research and development expenses (including expenses for general research) are allocated in the same manner as in example (1)."

These were the "rules set forth in § 1.861-8" when the DISC regulations were finalized. Just as the drafters of Prop. Treas. Reg. § 1.861-8 (1973) were clearly aware of the significance of the taxpayer's CTI product lines to the allocation and apportionment of R&D expenses for purposes of computing CTI, the drafters of the final DISC regulations were manifestly aware of the existence of the examples discussed above. The IRS Technical Memorandum that accompanied the proposed Treasury decision containing the 1975 final DISC regulations stated:

> Several comments [on the 1972 proposed DISC regulations] suggested that subdivisions (iii) and (iv) [of § 1.994-1(c)(6)] should be amplified to give rules and examples for determining the portion of certain expenses of the related supplier to be deducted in determining combined taxable income of the DISC and related supplier. *It was observed that the reference to § 1.861-8 is of no value without adequate regulations under that section, and that the thought in such subdivi-*

[13] Income from DISC sales of 4-cylinder engines and income from DISC sales of 6-cylinder engines were each treated as a statutory grouping.

> *sion (iii) is expressed in terms of the existing regulation rather than in terms of the outstanding [1966] proposed regulation.*
>
> Subsequent to receipt of these comments, a notice was published under § 1.861-8 on June 18, 1973 (38 F.R. 15840) which provides rules and examples for allocation and apportionment of expenses in determining combined taxable income of the DISC and related supplier. Hence, this suggestion was not adopted.

1974 TM LEXIS 30 at *20-21 (Oct. 29, 1974) (emphasis added).[14]

* * *

When it enacted the DISC provisions, Congress intended that each item of gross income would have allocated to it all "directly related" expenses (as well as a pro rata portion of "nonallocable" expenses). That was what Congress believed would be the result under "the principles applicable under section 861." Congress also intended that the DISC pricing rules could be applied on the basis of product lines.

The drafters of the DISC regulations carried out Congress' intent. Those regulations provide that (1) costs to

[14] A Technical Memorandum generally summarizes or explains proposed rules, provides background information, states the issues involved, identifies any controversial questions, discusses the approach taken by the drafter, and gives the reasons for that approach. *Taxation With Representation Fund v. Internal Revenue Service*, 646 F.2d 666, 671 (D.C. Cir. 1981). Although they do not have the authority of legislative history, Technical Memoranda provide similar evidence of the drafter's intentions.

be treated as relating to gross receipts from sales of export property include expenses "definitely related, and therefore allocated and apportioned, thereto" (as well as a ratable part of any other expenses not definitely related to a class of gross income), Treas. Reg. § 1.994-1(c)(6)(iii), and (2) at the taxpayer's election, determinations relating to CTI could be made on the basis of product lines, Treas. Reg. § 1.994-1(c)(7). The drafters believed that would be the result if costs were allocated and apportioned "in a manner consistent with the rules set forth in § 1.861-8."

Boeing allocated its product-specific R&D expenses only to the gross income from the relevant Program. That is what was intended by Congress, and that is what was intended by the drafters of the DISC regulations. That is also what a proper reading of the DISC regulations' cross-reference to Treas. Reg. § 1.861-8 will achieve.

Since a mechanical application of Treas. Reg. § 1.861-8(e)(3) does not achieve the result clearly intended both by the Congress that enacted the DISC provisions and by the drafters of the nearly contemporaneous DISC regulations, Treas. Reg. § 1.861-8(e)(3) should be interpreted, in the context of DISC CTI computations, as applying on the basis of the taxpayer's CTI product lines, rather than SIC categories. Such a reading both harmonizes Treas. Reg. § 1.861-8(e)(3) with the provisions of Treas. Reg. § 1.994-1 and carries out Congress' intent in enacting the DISC provisions. The decision below does neither.

CONCLUSION

The decision of the Ninth Circuit should be reversed. The Court should reverse either (1) on the same basis as the Eighth Circuit decided *St. Jude Medical*, holding Treas. Reg. § 1.861-8(e)(3) unreasonable, and therefore invalid, as applied in the computation of DISC CTI, or (2) on the ground that, properly interpreted in the context of the DISC provisions, Treas. Reg. § 1.861-8(e)(3) should be applied in the computation of CTI by treating the taxpayer's CTI product lines — rather than broad SIC categories — as the relevant product categories Under either approach, the decision below should be reversed.

Respectfully submitted,

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Allocation and Apportionment of R&D Deductions in Computing CTI

A U.S. corporation (X) manufactures product lines A, B, C, and D. X exports B, C, and D through its wholly owned DISC (Y). X and Y group transactions under Treas. Reg. § 1.994-1(c)(7) on the basis of the product lines sold by Y and use the CTI method. Sales for each product line are as follows:

	Domestic Sales	DISC Sales
A	600	-
B	-	800
C	400	1200
D	600	400

X has total R&D expenses of $100. Of that amount, $45 is for research related to A, $15 is for research related to B, and $40 is for research related to C. There is no research related to D.

Allocation

The R&D deductions are allocated $45 to the income from sales of A, $15 to the income from sales of B, and $40 to the income from sales of C.

Apportionment

There are three statutory groupings of gross income (income from DISC sales of B, income from DISC sales of C, and income from DISC sales of D). The residual grouping is other gross income (income from domestic sales).

The $45 R&D deduction allocated to the income from sales of A does not need to be apportioned because all the income from sales of A is in the residual grouping. The $15 R&D deduction allocated to the income from sales of B does not need to be apportioned because all the income from sales of B is in a single statutory grouping (income from DISC sales of B).

The $40 R&D deduction allocated to the income from sales of C is apportioned between the statutory grouping and the residual grouping based on the sales of C in each grouping:

					Grouping
DISC sales of C / Total sales of C	=	$1200 / $1600	x $40	= $30	*Income from DISC Sales of C*
Domestic sales of C / Total sales of C	=	$ 400 / $1600	x $40	= $10	*Residual*

Thus, X and Y deduct $15 in computing CTI from sales of B, $30 in computing CTI from sales of C, and nothing in computing CTI from sales of D.